Super Power or Super Haven – Part II

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In the 1980s, a new dimension to profit shifting was introduced in the United States through the establishment of Onshore Offshore Banks. New legislation (called the International Banking Facility (IBF)) allowed banks in the US to maintain two separate sets of accounts. One set capturing all transactions with residents of USA which would be subject to oversight by federal regulatory authorities in terms of interest rate ceiling, reserve requirements and compulsory insurance. The second set of accounts, capturing only the transactions of the banks with non-residents. This second set was not subject to any of the above regulations. Avoiding reserve requirements and rate ceilings meant higher profits for banks under the second set. Instead of creating a "shell" bank in one of the offshore havens, US banks could now create a fresh set of books of accounts *in which they could avail of the advantages of many offshore banking centers without the need to be physically offshore.*[1]

By preventing the IBFs from issuing certificates of deposit, the federal authorities created an impenetrable ring-fencing feature so that the domestic market is not adversely impacted by the harmful features of IBFs. Banking regulations were not the only ones exempted. Several states exempted the income of IBFs from income taxes and local taxes.

By any set of criteria, the introduction of Onshore Offshore Banks was abusive. Assessed against the criteria identified by the 1998 Report on Harmful Tax Competition[2], the results are telling,

The regime checks all the boxes that are the fundamental features of a harmful regime. However, the regime continued to extract deposits, nonchalantly, from across the globe, beefing up one country's reserves at the cost of others.

The 2008 Financial Crisis was a rude awakening to the United States. During a testimony before one of the U.S. House's subcommittees that was investigating the root causes for the scandal, it was testified that,

> *"We believe that the United States and its major trading partners have a major systemic problem of bank fraud that requires major systemic solutions."*[3]

This was stated in reference to the 1984 Tax Act. The existing abusive regime exempting interest income from deposits in American banks was, in 1984, extended to interest from US bonds. Non-residents lending money to US corporates in exchange for bonds would not be liable to tax on the interest that the US Corporate would be paying the non-resident. Since these bonds (often called Eurobonds) were issued in bearer form, the issuing company had absolutely no clue whose funds it was loaning. Since transactions of bond transfer were not registered on any exchange, it was strongly believed *those lending money in that market were not reporting the income on their investments to their home country. Whether by design or otherwise, the Eurobond market has provided an ideal investment environment for tax evaders.**[4]***

Since USA was not taxing the interest income on Eurobonds, there was a high probability the interest income was not being declared in the country of residence of the bond holder either. There was no means for the tax administration of the residence country to catch hold of these transactions since the United States had no information to share, quite conveniently. It is only understandable that the interest rates at which money was available in the Eurobond market was lower than that available in the domestic market. Cost of tax and cost of compliance were zero. Adequate precautions were introduced in law so as to prevent resident American taxpayers from investing in the regime so that the abusive nature of the regime doesn't adversely impact the domestic tax collection.

The exemption on interest earned from Eurobonds was outright abusive by any stretch of imagination. Assessed against the 1998 factors of abusive tax practices,

A toxic cocktail: Blending Exchange of Information and ring fencing

In 2001, United States implemented the U.S. Qualified Intermediary (QI) system which required financial institutions designated as a QI to identify their customers. If they were foreign customers, the QI could keep the identity of their customer secret as long as withholding was correctly done. For U.S. customers, the QI was required to report to the IRS any U.S. source income.[5] Notwithstanding the fact that the QI System was riddled with loopholes and had serious vulnerabilities, this was perhaps the largest experiment of fusing ring-fencing with Exchange of Information protocols. The regulation was planned in a way to make sure that information of non-residents investing in the US or earning income arising in the United States was not available with the IRS. Information pertaining to US residents was mandatorily submitted by the financial institutions to the IRS. With no information, the question of exchanging it with other jurisdictions does not arise.

The arrangement did not change when the Foreign Account Tax Compliance Act (FATCA) replaced the QI Program. Under FATCA, while foreign financial institutions that hold or process income of US residents must report the identity of their qualifying U.S. clients to the United States, the United States is still not obligated to exchange information pertaining to cash accounts of non-US residents and non-cash accounts of non-US residents unless the accounts earn US source income (remember how in earlier legislations, interest was classified as a non-US Source income though it was earned in US banks).

This means that while the Internal Revenue Service (IRS) receives information about U.S. persons' financial accounts in foreign financial institutions (FFIs), U.S. financial institutions (U.S. FIs) report little or no information about foreigners holding financial accounts in the United States.[6]

The OECD's Common Reporting Standard which is the global multilateral equivalent of FATCA, on the other hand, requires a full, reciprocal exchange of financial data from each partner who enters into the agreement. The United States has now taken the stance that since the FATCA is similar to the CRS, it does not have to implement the CRS.

It is widely understood that if a US trust appoints a non-US citizen and a non-US resident as its trustee, and if this trustee is resident in a non-CRS participating jurisdiction, the US trust as a Foreign Financial Institution (FFI) will be outside the scope of both FATCA reciprocity and the Common Reporting Standard.

It is an irony that the Forum on Harmful Tax Practices does not review ring-fenced Exchange of Information regimes. If it did, FATCA would be the first regime to be classified as a harmful one.

Defraud, Deceive and Dupe

The Federal level abusive features of the United States of America are only aggravated by the harmful measures taken at the state level in certain states, notably Delaware, Wyoming and Nevada.

Let's look at Delaware. Only home to **0.3%** percent of the U.S. population, Delaware is surprisingly home to **65%** of Fortune 500 companies and **80%** of publicly traded U.S. companies. If a business does not conduct its operations in Delaware, the state's corporate income tax may not apply. The classic territorial taxation system structure that says, "If you don't generate income here, we don't care where you're generating your income at, we are not going to tax you". The state does not have a corporate tax on interest or other investment income that a Delaware holding company earns. It has been already studied that Delaware, offers tax savings of between 15–24% in the state income tax burden[7]. While the financial capital of the world is no doubt New York City, which is conveniently located not one hundred miles away from Delaware's largest city, Wilmington. Thus, Delaware relies on luring companies from New York, New Jersey, and other similarly situated financial metropolises to bolster their own economy. For this reason, while other states were struggling to meet revenue quotas in a difficult economy in 2011, Delaware collected roughly $860 million in taxes and fees from its corporate residents, which accounted for almost a quarter of the state's total budget[8].

The Financial Crimes Enforcement Network of the United States Department of Treasury, testified in 2006, before the Senate Permanent Committee on Investigations, that**,** *of the four states often recognized as being particularly appealing for the formation of shell companies (Oregon, Wyoming, Nevada, and Delaware), only Delaware falls in the group offering the least transparency. The other three states fall in the group offering a moderate level of transparency**[9]***. It rarely gets more conspicuous than this.

Delaware's tax laws are abusive without a doubt. Assessed against the 1998 factors of abusive tax practices,

Delaware goes much beyond taxes. If there's something that connects Viktor Bout, a convicted Russian arms dealer who allegedly smuggled anti aircraft missiles to Colombia and aided terrorist organisations, Jack Allan Abramoff, widely known as America's most notorious lobbyist, convicted for swindling Native American tribes, Laszlo Kiss, a Romanian accountant convicted for laundering millions of Euros, or Timothy Durham**,** an American lawyer and financier convicted in 2012 of one of the largest Ponzi schemes in United States history, it is Delaware[10]. Delaware is an integral aspect and a cornerstone in each of the convoluted schemes that were devised to defraud, deceive and dupe.

Way Forward

The United States sits at the centre of global financial flows, with a red cape fluttering at its back, blissfully unaware of or conveniently abetting the complex contortions and undulating twists that its abusive practices lend to investment flows, trade shipments and corporate structures. The US's Foreign Derived Intangible Income (FDII) legislation is the next weapon in its armory. While still being reviewed by the FHTP, five EU Finance Ministers have already expressed their concern on the FDII regime being not compatible with the BEPS consensus. The FDII regime clearly deviates from the agreed criteria for harmful regimes by providing benefits to intangible income without due consideration to substantial research and development (R&D) activities. While FHTP's designation as the regime as being potentially harmful may not lead directly to international sanctions since the OECD is not a sovereign body, it will definitely enable countries to take unilateral defensive measures against FDII and will be one of the first steps against the global charade of tax abuse.

The views expressed in this blog are personal to the author.

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[2] OECD, Harmful Tax Competition: An emerging global issue, 19th May 1998, ISBN: 9789264162945, https://doi.org/10.1787/9789264162945-en, Accessed 4th March 2020.

[3] Testimony of Michael J. McIntyre and Robert S. McIntyre On Banking Secrecy Practices and Wealthy American Taxpayers Before the U.S. House Committee on Ways and Means Subcommittee on Select Revenue Measures March 31, 2009, Accessed from https://www.ctj.org/pdf/mcintyresw&mtestimony20090331.pdf on 4th March 2020

[4] Ibid.

[5] William Byrnes and Robert J. Munro, Background and Current Status of FATCA, Legal Studies Research Paper Series Research Paper No. 17–31, Texas A&M University, School of Law.

[6] Allison Christians, *What You Give and What You Get: Reciprocity Under a Model 1 Intergovernmental Agreement on FATCA*, Cayman Fin. Rev., Apr. 2013, at 24, 24; Peter A. Cotorceanu, *Hiding in Plain Sight: How Non-U.S. Persons Can Legally Avoid Reporting Under Both FATCA and GATCA*, 21 Trusts & Trustees 1050, 1050 (2015)

[7] Dyreng, S. D., Lindsey, B. P., and Thornock, J. R. (2013). Exploring the role Delaware plays as a domestic tax haven. Journal of Financial Economics, 108(3):751–722.

[8] Poole, Katherine (2019) "The Middle-Class: Shouldering the Burden of Corporate Tax Havens and the Encumberment of Economic Globlization," *SPICE: Student Perspectives on Institutions, Choices and Ethics:* Vol. 14 : Iss. 1 , Article 4. Available at: https://repository.upenn.edu/spice/vol14/iss1/4

[9] Statement of associate director, for regulatory policy and programs, jamal el-hindi, financial crimes enforcement network, united states department of the treasury, November 14, 2006, Before the Senate Permanent subcommittee on investigations,

[10] Leslie Wayne, 2012, How Delaware thrives as a Corporate Tax Haven, The New York Times, Accessed at : https://www.nytimes.com/2012/07/01/business/how-delaware-thrives-as-a-corporate-tax-haven.html.